Testimony of

Keith Collins
Chief Economist
United States Department of Agriculture

before the

Committee on Agriculture, Nutrition, and Forestry
United States Senate
July 20, 2006

Mr. Chairman, and Members of the Committee, thank you for the opportunity to appear before you today to discuss the structural changes occurring in the dairy industry, the economic outlook for milk and dairy products and the recent performance of Federal dairy programs as the Committee prepares for the 2007 Farm Bill. We will begin by briefly highlighting the outlook for milk and dairy products and the structural changes occurring in the dairy industry and then focus on the primary dairy programs administered by three U.S. Department of Agriculture (USDA) agencies: the Farm Service Agency (FSA), the Foreign Agricultural Service (FAS), and the Agricultural Marketing Service (AMS).

Changing Structure of the U.S. Dairy Industry

U.S. dairy farming has changed dramatically in the last 20 years. Many of these dairy sector changes are the result of market conditions, technological change, productivity growth, economies of scale, and regional shifts.

In the 1930s, nearly 60 percent of milk marketed went for fluid consumption and milk and dairy products were marketed in close proximity to where the milk was produced. Dairy enterprises were often just one aspect of diversified farming operations. Considerable volumes of milk were separated on the farm into skim and cream, with the cream sold to dairy manufacturing plants and the skim milk fed to hogs or other livestock. The manufacturing dairy product industry was concentrated in the Northeast and Upper Midwest.

Now, only 36 percent of milk marketed is consumed as fluid milk and California is the nation's leading milk producing State and the nation's second largest producer of cheese. Milk used on farms where produced has all but disappeared. Due to improvements in transportation and processing, fluid milk markets have expanded from local to regional in scope, and now national markets exist for manufactured dairy products.

Over time, shifts have occurred in consumer preferences for milk and dairy products. Per capita consumption of all dairy products has increased with major growth occurring in per capita consumption of cheese, while fluid milk consumption on a per capita basis has been declining. Per capita consumption of cheese increased by over 75 percent from 1980-2005. Less than half of all cheese is now sold at retail in the form of ready-to-eat or prepared-at-home cheese. Cheese has become a major ingredient in many other foods sold through grocery stores and restaurants.

The structure of milk production is also changing. Advances in technology and improvements in productivity have caused the number of dairy farms to decline and average farm size to increase. Milk yields per cow have increased steadily thanks to genetic breakthroughs, improved herd management, and scientific methods that promote output growth. Since 1980, milk output per cow has risen by 50 percent and milk production has increased by nearly one-third, while the number of cows has declined.

Fewer cows, coupled with increased economies of size, have led to a decline in the number of U.S. dairy farms by more than 70 percent between 1980 and 2003, while the average herd size has increased 300 percent. In 1980, 60 percent of all U.S. dairy farms had 1-29 dairy cows. By 2002, less than 30 percent of U.S. dairy farms fell into that same range. Although dairy farms with small herds still outnumber farms with very large herds, production is increasingly concentrated on the largest farms. Less than 4 percent of U.S. dairy farms have more than 500 cows but these farms produce nearly 50 percent of the Nation’s milk.

A favorable climate for milk production, ample supplies of good quality forage, and innovations in technology have caused milk production to expand in the West. Farms in this region of the country tend to be larger and have lower production costs, on average, than farms

in other regions of the country. Likewise, dairy processing plants, with the advantages inherent with economies of size, are following milk production operations in this westward expansion.

Outlook for Dairy

Dairy farmers benefited from record high milk prices in 2004 and near-record high prices in 2005 following a two-year period of low producer milk prices. As a result, milk production continues to increase in response to those strong prices, restored availability of a hormone that boosts milk productivity per cow, and generally good forage conditions. In 2006, milk production is forecast to reach 182.1 billion pounds, up nearly 3 percent over 2005. The all-milk price is forecast to average between $12.50 and $12.80 per cwt. in 2006, compared with $15.14 in 2005.

USDA forecasts milk production to expand slightly to 183.1 billion pounds in 2007, or up less than 1 percent, as producers begin to reduce cow numbers in response to higher feed and fuel costs and lower milk prices in 2006. The 2007 all-milk price is forecast to increase and average between $12.85 and $13.85 per cwt., up about 6 percent over 2006, as the result of lower production growth coupled with continued expansion in demand for milk and dairy products.

In FY 2005, U.S. dairy exports hit a record $1.7 billion, as U.S. milk producers have benefited from tight world supplies of dairy products and a relatively weak U.S. dollar over the past two years. Reduced milk production in New Zealand, Australia and the European Union (EU) limited their supplies available for export and robust international demand caused the world price for nonfat dry milk to rise above the support price enabling the United States to be competitive in the world market without the use of export subsidies. In 2005, U.S. exports of nonfat dry milk increased to 611 million pounds, up 20 percent from 2004 and nearly 150 percent above 2003. U.S. imports of butter and American-type cheese declined in 2005,

reflecting some moderation in U.S. prices for those dairy products after reaching record high levels in 2004. In contrast, U.S. imports of milk protein concentrate increased from 97 million pounds in 2004 to 121 million pounds in 2005 but remained well below the peak of 143 million pounds in 2000.

Trade conditions are similar for 2006. Global demand for dairy products remains firm, the U.S. dollar continues to be favorable to exports, and U.S. nonfat dry milk prices are expected to remain competitive without export subsidies.

Evolving Dairy Policy: 1930s to 2002

Federal dairy programs have existed in various forms for 70 years having their origins in the depression era of the 1930s. In the 1930s, economic conditions were depressing dairy farmers' income, milk processing and storage capacity was limited and milk marketings were highly variable. Dairy co-ops in existence at that time were unable to stabilize the market for milk and dairy products. To address these concerns, Congress passed the Agricultural Marketing Agreement Act of 1937 authorizing Federal Marketing Orders and Agreements for milk and other agricultural products. The introduction of Federal milk marketing orders helped to stabilize the market by establishing minimum prices handlers must pay for milk.

Since the authorizing legislation was passed in 1937, the Act has been amended numerous times and Federal milk marketing orders are continually being updated through an administrative producer hearing and referendum process. Major changes have included adjusting the number of orders, adopting a uniform classification of products and tying minimum milk prices to manufactured product wholesale prices when the relevancy of the competitive pay price series as a market indicator came into question.

From the inception of the program until the mid-1960s, the number of milk orders increased, peaking in 1962 at 83. Orders began to be merged in the 1960s in response to the development of more efficient refrigerated transportation systems, interstate highways, bulk milk assembly from farms, and the economic changes associated with growth of metropolitan regions and higher-volume fluid milk processing plants. By 1996, the number of orders was reduced to 32 as this merger activity continued. Federal order consolidation and reform, as required by the Federal Agriculture Improvement and Reform Act of 1996 (the 1996 Farm Bill), was implemented in January 2000 and reduced the number of orders to 11. The Western Order was terminated on April 1, 2004, leaving 10 active orders in the current system.

Milk use classes have been adjusted from time to time to reflect the development of new dairy products and advances in milk manufacturing technology. A uniform classification system was implemented across all Federal milk marketing orders in 1974, recognizing that large regional plants were operating across multiple orders and competing regionally for sales of fluid milk and dairy products. Implementation of a uniform classification system meant that processors making like products had uniform or comparative costs. This eliminated the regulatory inefficiencies and different local market definitions, which had begun to create competitive inequities.

Early in the 1960s, the Minnesota-Wisconsin manufacturing grade (Grade B) milk price (the M-W price) became the mover for class prices under most Federal milk marketing orders. The M-W price was the average price received by producers for Grade B milk in Minnesota and Wisconsin as reported by the National Agricultural Statistics Service. The M-W price became widely used throughout the industry as a basic indicator of changes in the farm value of milk.

Use of this competitive Grade B pay price series kept Federal Class prices closely aligned with market values for milk.

After a decade of use, questions were raised concerning the continued use of the M-W price by Federal orders since the volume of Grade B milk was declining. In 1995, after numerous studies of alternatives, a "basic formula price (BFP)" was adopted as a replacement. The BFP was the previous month's value of Grade B milk in the Minnesota-Wisconsin area updated to the current month by a product formula that adjusted the M-W price for changes in the wholesale prices of butter, cheese and nonfat dry milk. However, by 2000, the volume of milk upon which the BFP was determined represented less than 5 percent of U.S. production. Thus, in 2000, as part of Federal milk marketing order consolidation and reform, USDA adopted product price formulas as the basis for pricing all regulated milk because of continuing concerns regarding the accuracy of the BFP as an indicator of the value of milk. The use of wholesale dairy product prices continues to link Federal order milk prices to market supply-demand conditions for milk and dairy products.

The first Federal milk price support program was authorized by the Agricultural Adjustment Act of 1938. The Agricultural Act of 1949 (1949 Act) provided permanent authority for the milk price support program and for support programs of other agricultural commodities. The 1949 Act authorized the Secretary of Agriculture to support the price of milk at 75 to 90 percent of parity by purchasing processed dairy products (butter, nonfat dry milk, and cheese). Parity was a price based on the relationship between farm milk prices and the price of farm inputs during the 1910-14 base period.

A burgeoning oversupply of dairy products coupled with escalating program costs in the early 1980s led Congress to cut the link between the milk support price and parity and to

gradually lower the support price. Congress also authorized the Milk Diversion and the Dairy Herd Termination Programs and assessments on milk marketings in efforts to reduce milk production, price support purchases and program outlays. From 1988 to 1995, Congressionally-mandated triggers related to quantities of products purchased were used to adjust the support price. Dairy price support program expenditures, which peaked in FY 1983 at $2.5 billion, declined to less than $0.5 billion in FY 1990, reflecting the decline in the milk support price and assessments paid by dairy producers.

The 1996 Farm Bill authorized termination of the milk price support program on January 1, 2000, and replacing it with a processor recourse loan program. But, dairy prices began to fall in the late 1990s and Congress responded by authorizing emergency supplemental payments to dairy producers and extending the support program.

Current Federal Programs for Milk

Current dairy policy rests on the historical goal to ensure an adequate milk supply through price and income support and orderly marketing. These Federal dairy policy objectives are pursued through several programs managed by USDA, including:

- Milk Price Support Program (MPSP);
- Counter-cyclical payments under the Milk Income Loss Contract (MILC) program;
- Dairy Export Incentive Program (DEIP);
- Federal milk marketing orders (FMMO); and
- Grading, product standards, market news, research and promotion.

Price and Income Support Programs. USDA's price and income support programs for milk and dairy products include: the MPSP, the MILC program and the DEIP. **The MPSP** was

initially authorized by the Agricultural Act of 1949 and has been amended numerous times, most recently by the Farm Security and Rural Investment Act of 2002 (2002 Farm Bill). The 2002 Farm Bill mandates that USDA support the price of milk at $9.90 per cwt. through December 31, 2007.

Under the MPSP, purchase prices are established for butter, cheese and nonfat dry milk at a level that enables processors of average efficiency to pay producers an average price that is not less than $9.90 per cwt. for milk containing 3.67 percent milk-fat. The Secretary of Agriculture may adjust the Commodity Credit Corporation (CCC) purchase prices of nonfat dry milk and butter twice within a calendar year to achieve the lowest level of expenditures by CCC or achieve such other objectives as the Secretary considers appropriate. USDA last made an adjustment in the purchase prices of butter and nonfat dry milk in November 2002. CCC maintains an open, standing offer to purchase butter, cheese, and nonfat dry milk from dairy processors at the announced purchase prices. CCC arranges for delivery of the purchased milk products to contracted commercial storage space and makes surplus inventory available for domestic and foreign food assistance programs and for other purposes.

The CCC inventory of nonfat dry milk reached a peak of 1.4 billion pounds in 2003. Stronger milk prices, a lower purchase price for nonfat dry milk (offset by an increase in the purchase price for butter), donations under domestic and foreign food assistance programs, implementation of livestock feed assistance programs and sales for both restricted and unrestricted uses reduced the inventory of nonfat dry milk held by the CCC to 11.5 million pounds on June 9, 2006. The net realized losses to CCC for the inventory reduction during FY 2003-06 exceeded $2.2 billion. From October 1, 2005 through July 7, 2006, 62.3 million pounds of nonfat dry milk have been offered to the CCC under the MPSP of which 38.5 million pounds

have been taken into CCC inventory. In calendar year 2006, CCC purchases of nonfat dry milk are projected to reach 105 million pounds, while little to no purchases of butter and cheese are forecast under the price support program.

The **MILC** program was authorized by Section 1502 of the 2002 Farm Bill and extended through September 30, 2007 by Section 1101 of the Deficit Reduction Act of 2005. The MILC program replaced previous Dairy Market Loss Assistance (DMLA) programs that provided payments to dairy producers from 1997 through 2000 and was implemented soon after authority for the Northeast Interstate Dairy Compact expired.

The MILC program provides counter-cyclical payments to milk producers on a monthly basis when the Boston Federal Milk Marketing Order Class I price for fluid milk falls below $16.94 per cwt. Each farm operation is limited to receiving payments on 2.4 million pounds of eligible milk marketings per fiscal year. For production marketed between December 1, 2001 and September 30, 2005, milk producers on eligible dairy operations received a payment equal to 45 percent of the positive difference between $16.94 per cwt. and the Boston Class I price. The 45 percent payment rate was equivalent to the rate paid under the Northeast Interstate Dairy Compact. For production marketed between October 1, 2005 and August 31, 2007, the payment rate percentage declines to 34 percent and to zero percent on September 1, 2007 of the positive difference between $16.94 and the Boston Class I price.

Dairy producers have received more than $2 billion in counter-cyclical payments under the MILC program for production marketed during fiscal years 2002 through 2005. Because of ongoing work to improve computer software, it took FSA less than 60 days from the time the legislation reauthorizing the extension of the MILC program was signed by the President in February 2006 to implement the new changes and begin processing payments to producers. As

of July 10, 2006, more than $150 million has been received by dairy producers since payments began in April 2006.

USDA is also responding to the risk management needs of the dairy and livestock sectors by providing whole farm revenue insurance. The Risk Management Agency's (RMA) "Adjusted Gross Revenue Lite" pilot revenue insurance policy is currently available in 17 States and is being considered for expansion into 15 additional States for 2007.

The **DEIP** was initially authorized by the Food Security Act of 1985 and extended by the 2002 Farm Bill. The purpose of DEIP is to develop international markets for U.S. dairy products and to counter EU export subsidies on dairy products. Under DEIP, exporters of nonfat dry milk, cheese and butter can receive payments to increase the competitiveness of these dairy products in world markets, boosting U.S. dairy product export sales. Increased export sales, in turn, lead to higher prices for U.S. dairy products and higher prices to dairy producers.

Under the Uruguay Round Agreement on Agriculture (URAA) export subsidy disciplines, DEIP exports are limited by quantity annually (July/June) to 68,201 tons of nonfat dry milk, 21,097 tons of butterfat and 3,030 tons of cheese. Annual (October/September) monetary limits also exist on DEIP assisted exports and are $82.5 million for nonfat dry milk, $30.5 million for butterfat and $3.6 million for cheese. USDA is constantly evaluating market conditions to determine whether program implementation is justified. Over the past two years, DEIP has not been activated due to high world prices, which are enabling U.S. dairy exports to be competitive without the need of DEIP assistance. This is in large part due to the scaling back of EU export subsidies as a result of mounting budgetary pressures and the export subsidy disciplines prescribed by the URAA.

After interagency and USDA approval, DEIP can be implemented through a public announcement followed by an "invitation to bid" issued to dairy exporters. Exporter bids for a payment bonus are evaluated and allowable bonuses are estimated to cover the differential between global and domestic prices. Awards are made to exporters starting with the lowest bonus requested.

Marketing Programs. USDA administers several programs to facilitate the marketing of milk and dairy products in the domestic and international marketplace, while ensuring fair trading practices, and promoting a competitive and efficient marketplace to the benefit of producers, processors and consumers of milk and dairy products. These programs include: Dairy Market News, the Dairy Products Standards and Grading Programs, the National Dairy Promotion and Research Program, the National Fluid Milk Processor Promotion Program and the Federal Milk Marketing Order Program. These activities are important to the dairy industry because they support both the domestic and international marketing of U.S. dairy products.

The **Dairy Market News** (DMN) program was established under the Agricultural Marketing Act of 1946 (Act) which authorizes funds "to collect and disseminate marketing information, including adequate outlook information, on a market-area basis, for the purpose of anticipating and meeting consumer requirements, aiding in the maintenance of farm income, and bringing about a balance between production and utilization of agricultural products." The information provided by DMN enables dairy farmers, milk processors and other milk and dairy product businesses to better compete by providing high quality, unbiased, timely and accurate economic information on prices, consumption, production and other data for dairy products traded in specific regional, national and global markets. This information assists in the orderly marketing of milk and dairy products and in making market conditions more competitive. Users,

representing the full spectrum of the milk and dairy product industry, have direct access to a wide variety of public data made available through several dissemination methods. DMN contributes to efficient market performance by bringing transparency to the marketplace. The existence of DMN ensures free and full access to current, reliable, and unbiased market information for all market participants.

Dairy product standards are an important factor in facilitating commercial trade of dairy products. Rather than compositional standards of identity, which are frequently provided by the Food and Drug Administration, USDA establishes standards that relate to the quality and physical attributes of dairy products, such as taste, smell, texture, appearance and color.

AMS maintains 17 grade standards and 16 quality specifications for dairy products. Dairy products for which there are grade standards may be graded by USDA inspectors, and if approved, may carry a USDA shield showing the product meets the assigned grade. Both grade standards and quality specifications provide a uniform basis for reporting supply, demand and price statistics for such dairy products in *Dairy Market News*.

In addition, USDA actively participates in several international standards setting organizations. Membership in the International Dairy Federation (IDF) allows USDA to play a critical role in the preparation of product standards proposals that are subsequently considered by the CODEX Alimentarius Commission. CODEX is the global reference point for international consumers, food producers and processors and is recognized by the World Trade Organization as an important reference for international trade disputes over sanitary measures.

USDA's dairy product **grading, certification and verification services** provide important third-party services that facilitate commercial sales of dairy production in both domestic and world markets. These services are voluntary and are funded by users. During

2005, USDA employees graded 1.7 billion pounds of butterfat, butter, cheese and nonfat dry milk, representing about 15 percent of total production of those products. Almost all of the butter produced in the United States is graded and carries the USDA quality shield. USDA employees also performed 727 plant inspections and 241 equipment inspections.

An important and growing part of USDA's dairy product grading activities is the issuance of export certificates for dairy products. These certificates attest that U.S. dairy product exports (1) are fit for human consumption, (2) were produced under sanitary conditions and (3) are free from certain animal diseases. When an export certificate accompanies exported dairy products, it assures the buyer that the product was produced under a system of regular audits and inspections to assure that the products meet U.S. requirements for quality and condition. More than 80 importing countries now require or accept USDA dairy export certificates. Often these certificates are required documents for commercial banks clearing letters of credit assuring payment for products.

In 2005, AMS issued 3,568 export certificates covering more than 460 million pounds of dairy products. The certificate program has grown rapidly since it was initiated in 1997, both in volume and the number of certificates issued. In 1997, there were 865 certificates issued on 15.1 million pounds; during 2000, there were 2,309 certificates issued on 36.6 million pounds; and, in 2004, AMS issued 3,521 certificates on 128.7 million pounds of dairy products. Also, the number of different products for which certificates are issued has expanded.

USDA has oversight of dairy **promotion and research programs**, which include the National Dairy Promotion and Research Program and National Fluid Milk Processor Promotion Program. In 2005, the National Dairy Promotion and Research Program and the National Fluid Milk Processor Promotion Program collected more than $273 million and $107 million in

assessments, respectively, to develop and implement programs to expand consumption of milk and dairy products.

The enabling legislation for both the producer and fluid milk processor promotion programs requires USDA to submit an annual report to the House Committee on Agriculture and the Senate Committee on Agriculture, Nutrition, and Forestry. These reports include benefit-cost analyses which indicate that dairy promotion efforts return to the dairy farmer more than $4.00 for every dollar invested in recent years and fluid milk consumption would have been about 9.7 percent less if fluid milk processors had not funded their generic promotion program.

The National Dairy Promotion and Research Program has focused recently on the away-from-home market to promote the expansion of fluid milk flavors and a greater range of packaging in foodservice and restaurants. Dairy Management Inc. (DMI), the staffing and management organization for the National Dairy Promotion Program, has partnered with several restaurant chains to increase their sales of fluid milk. Thus far, during the initial launch in 20,000 restaurants, combined weekly average milk sales have grown sharply. Other restaurant chains will have national rollouts of single-serve containers this summer. In addition to milk, the National Dairy Promotion Program is partnering with a fast food chain to test and market a 7-ounce strawberry yogurt cup that is now a permanent menu option.

The National Fluid Milk Processor Program has been capitalizing on recent research studies that show that the consumption of the amount of calcium contained in three glasses of milk appears to enhance weight loss efforts when combined with a reduced calorie diet and exercise. These generic advertisements, which encourage the consumption of reduced fat milk, are consistent with USDA food pyramid and dietary guidelines. The National Fluid Milk Processor Program also has been advancing the distribution of milk in vending machines.

Federal milk marketing orders are a major part of milk marketing in the United States. In 2005, 114.7 billion pounds, or about 65 percent of total milk marketings, were regulated under Federal milk marketing orders. This is down from 69 percent in the 1990s and 70 percent in the 1980s. The number of producers delivering milk to handlers regulated under Federal milk marketing orders each month in 2005 averaged 53,036, or about 82 percent of all licensed dairy herds.

The Federal milk marketing order system facilitates the marketing of milk by dairy farmers and their cooperative associations, except in certain States and regions. Federal orders regulate handlers who buy milk from farmers and cooperatives for use in fluid milk products. The Federal order under which a handler is regulated depends on where a handler sells fluid milk products, except when the handler is located in a Federal milk marketing order and sells into a State that regulates milk pricing.

Federal orders set minimum prices paid by regulated handlers for milk according to how it is used. Federal order minimum prices for milk in manufacturing uses reflect the wholesale prices of manufactured dairy products, manufacturing costs and milk-to-product conversion factors. The wholesale prices of manufactured dairy products are determined through a national weekly USDA survey of sales by wholesale manufacturers. Minimum Class I (fluid) milk prices are based on current minimum prices for milk in manufacturing uses plus differentials that reflect the additional costs of marketing milk for fluid uses at different locations. Market-generated Class I prices generally exceed Federal order minimum Class I prices, the differences commonly referred to as over-order premiums. Over-order premiums are regularly generated for milk used in other classes as well.

Dairy farmers who supply enough milk to a market's fluid handlers to meet an order's performance standards share in the revenue of all milk sales under the order. Regardless of how an individual dairy farmer's milk is used, the farmer receives at least the blend or market average minimum price for milk sold in all classes. Thus, Federal milk orders provide a structured means of sharing a portion of the market revenues from all the milk sold under the order and compensating for the additional costs of supplying the Class I needs of a market.

The Federal milk order program amasses a considerable amount of data on producer numbers, milk marketings, prices, fluid milk sales and dairy product production that USDA makes available for all market participants. Much of the data are audited by Federal employees assuring the accuracy of the information. In addition, the Federal order program provides weighing and testing services to dairy farmers who do not receive such services from a cooperative association. This assures that payments to producers accurately reflect the volume and quality of milk sold. The funding for the Federal milk order program is derived from assessments, except for $16 million for oversight of marketing agreements and orders.

Federal milk marketing orders do not regulate the volume of milk dairy farmers can sell nor do they guarantee a market for a producer's milk. Producers must find their own market and must arrange for the delivery of their milk to the handlers.

In May of this year, USDA issued a recommended decision redefining the fluid milk product definition under Federal milk marketing orders. Under the proposed definition, products containing more than 6.5 percent nonfat milk solids or greater than 2.25 percent true protein and less than 9 percent milkfat will be classified as Class I products. The 6.5 percent nonfat milk solids and the 9 percent milkfat standards are unchanged from the current definition. The 2.25 percent true protein standard, proposed by the dairy industry, relates to the amount of true

protein contained in 6.5 percent nonfat solids. The 2.25 percent true protein standard would be relevant in classifying dairy beverages, such as those with reduced carbohydrates. Drinkable yogurt containing greater than 20 percent yogurt and specially formulated products for infants and the infirmed are proposed to be classified as Class II products.

A national hearing on the level of manufacturing (make) allowances used to calculate the value of Class III (milk used in cheese products) and Class IV milk (milk used in the production of butter and milk powder) products was held in January of this year. After evaluating the hearing record, USDA found that the evidence presented was insufficient for determining the appropriate and reflective costs of manufacturing milk into Class III and Class IV dairy products. Therefore, USDA announced the reconvening of the national public hearing to amend the make allowances. The hearing will be reconvened following the public release of data by Cornell University that reflects the costs of manufacturing by a sample of plants which include cooperative and proprietary plants and small, medium and large plants. In addition, USDA has requested proposals on the entire Federal order Class III and Class IV price formulas. Additional proposals are due on or before September 30, 2006. USDA will proceed as expeditiously as possible on this issue.

Several hearings have been held for the Upper Midwest, Mideast and Central orders that address pooling and re-pooling issues. Interim rules and recommended decisions have been issued. Recommended decision comments were due on April 24, 2006 for all three orders and final decisions are being prepared.

A hearing on transportation credits was held for the Southeast and Appalachian orders on January 10-12, 2006. Briefs were due on March 21, 2006. USDA is in the process of evaluating the record evidence and expects to issue a decision shortly.

Critical Issues and Challenges

We offer some critical issues and challenges for your consideration as this Committee contemplates future U.S. dairy policy. Trade agreements are very important to U.S. agriculture. In FY 2006, the value of U.S. agricultural exports is projected to reach a record $67.0 billion. The URAA increased market access and placed limits on export subsidies, and new multilateral and bilateral trade agreements will provide additional market opportunities for our farmers and ranchers. With respect to dairy, disciplines on export subsidies will ensure that the EU will not return to the massive subsidies that have often pushed international market prices for dairy products artificially low.

Under the URAA, farm programs in which payments are tied to current prices and/or production – or programs that support domestic prices – are considered to be "trade-distorting" and, therefore, included in a country's aggregate measurement of support (AMS). The United States currently has an AMS limit of $19.1 billion, and reported total trade-distorting support of $14.4 billion in 2001, of which $4.5 billion, or 32 percent, was represented by the MPSP. The United States has offered to reduce its bound AMS in the DOHA Round of trade negotiations by 60 percent, or from $19.1 billion to $7.6 billion. If the U.S. proposal is adopted, then modification of the MPSP may be necessary for the United States to meet its commitment on trade-distorting support.

The effectiveness of continuing government purchasing of surplus dairy products through the MPSP, versus offering alternative risk management programs, should be considered in the next Farm Bill. Continued growth of revenue insurance products, use of long term contracting and other risk management tools could be more effective and less market distorting than the MPSP.

Under the MILC program, strict statutory language precluded USDA from altering, expanding or clarifying the definition of dairy operation in any manner other than what was prescribed by the statute. While USDA's administration of the MILC program is consistent with the statute, an audit by USDA's Office of Inspector General (OIG) found variation in how the definition of dairy operation is applied. This inconsistent definition is an issue raised by OIG that USDA cannot remedy administratively.

USDA's cost-benefit assessment of the extended MILC program found that MILC is not expected to have a significant impact (less than 0.2 percent) on total U.S. milk production. In comparison, milk production increased 3.5 percent in 2005. Performance of the MILC program is being assessed by monitoring the effects of MILC payments on slowing the exit of small to medium sized producers. However, it is estimated that the share of milk production and number of producers in these size classes will continue to decline even with continued MILC payments.

The Congressional Budget Office (CBO) cost estimate for MILC at the time the 2002 Farm Bill was enacted amounted to about $1 billion through September 30, 2005. In contrast, MILC payments exceeded $2 billion through September 30, 2005. Because the payment rate under the MILC program falls to zero on August 31, 2007, the program will be authorized but there will be no MILC payments in the budget baseline. Thus, if Congress decides to extend MILC into the future, it will have to decide how much to spend on the program and what proportion of the increase in spending on the MILC program should come from cuts in other programs. The level of funding for MILC could affect the payment rate under the program and the amount of milk marketings eligible for payment.

In July 2004, USDA submitted to Congress a report titled "Economic Effects of U.S. Dairy Policy and Alternative Approaches to Milk Pricing." That report concluded that "Federal

dairy programs have a limited impact on profitability and viability of dairy farms." Congress may want to consider the impact of various dairy programs on trade, farm size and cost when developing the 2007 Farm Bill.

Many in the dairy industry have expressed concern regarding the length of time involved to amend Federal milk marketing orders. USDA recently undertook an extensive internal review of the process for amending Federal orders and has developed several new rulemaking initiatives and customer service standards. The goal is to improve timeliness and transparency while maintaining the opportunity for public involvement that currently exists. Through this initiative, USDA expects to reduce the time required to complete regulatory actions by over one-third.

Summary

The structure of the dairy industry continues to undergo substantial structural change. The number of dairy farms continues to decline as smaller dairy farms drop out of dairy farming or expand to become more economically viable, while the number of large dairy farms continues to expand as producers take advantage of economies of size. In addition, the climate, availability of good quality forage, and other factors are causing milk production to continue to shift to the West. Federal dairy policy will likely have only minor effects on these structural changes.

Federal dairy policy has continued to evolve since the 1930s when 60 percent of milk marketings were used for fluid consumption, compared with 36 percent fluid use today. This legacy should be reviewed under today's marketplace conditions. Extensive government intervention under current programs may not be necessary for providing orderly marketing in milk markets and adequate supplies of high-quality dairy products at reasonable prices.

The Federal budget deficit, market conditions of milk and dairy products, international trade agreements and the effects of the programs on producers, processors and consumers are factors that Congress may want to consider when debating whether to extend the MPSP and the MILC program in the 2007 Farm Bill or replace them with new tools. While price supports and direct payments help to protect producers during periods of low prices, both programs distort market signals and encourage producers to maintain production throughout periods of low prices. Changes to the Federal milk marketing order price formulas can also impact the cost of the MPSP and the MILC program. Furthermore, the MPSP and the MILC program are considered to be trade-distorting programs and subject to discipline under the WTO. Extending the MILC program would add to projected baseline spending and Congress will have to consider whether and how to offset that increase in spending.

We look forward to working with you and your Committee members in the months ahead. Thank you.

Chart 1. Milk Production, Utilization, CCC Removals and Price by Calendar Year

Item	Units	2002	2003	2004	2005	2006	2007
Number of cows	Thous	9,139	9,083	9,012	9,041	9,120	9,030
Milk per cow	Lb.	18,608	18,761	18,968	19,577	19,965	20,275
Milk production	Bil. lb.	170.1	170.4	170.9	177.0	182.1	183.1
FAT BASIS							
Marketings	Bil. lb.	168.9	169.3	169.8	175.9	181.0	182.1
Beg. commercial stks	Bil. lb.	7.0	9.9	8.3	7.2	8.0	8.2
Imports	Bil. lb.	5.1	5.0	5.3	4.6	4.4	5.1
Commercial supply	Bil. lb.	181.1	184.2	183.4	187.7	193.4	195.4
Commercial use	Bil. lb.	170.9	174.7	176.4	179.7	185.2	187.5
Ending commercial stks	Bil. lb.	9.9	8.3	7.2	8.0	8.2	7.9
Total utilization	Bil. lb.	180.8	183.0	183.5	187.7	193.4	195.4
CCC net removals 1/	Bil. lb.	0.3	1.2	-0.1	0.0	0.0	0.0
SKIM SOLIDS BASIS							
Marketings	Bil. lb.	168.9	169.3	169.8	175.9	181.0	182.1
Beg. commercial stks	Bil. lb.	8.1	8.5	8.5	8.2	9.0	9.0
Imports	Bil. lb.	5.1	5.0	4.8	4.5	4.7	5.7
Commercial supply	Bil. lb.	182.1	182.8	183.1	188.6	194.6	196.8
Commercial use	Bil. lb.	163.9	166.2	173.7	180.6	184.4	185.7
Ending commercial stks	Bil. lb.	8.5	8.5	8.2	9.0	9.0	8.8
Total utilization	Bil. lb.	172.4	174.7	181.9	189.6	193.4	194.5
CCC net removals 1/	Bil. lb.	9.7	8.1	1.3	-1.0	1.2	2.3
CCC NET REMOVALS 1/							
Butter	Mil. lb.	0	29	-7	0	0	0
Cheese	Mil. lb.	16	41	6	-2	0	0
Nonfat dry milk	Mil. lb.	824	664	105	-81	105	195
DEIP EXPORTS							
Butter	Mil. lb.	0	22	1	0	0	0
Cheese	Mil. lb.	3	6	6	0	0	0
Nonfat dry milk	Mil. lb.	162	149	106	0	0	0
PRICES REC'D BY FARMERS							
Class III	Dol/cwt	10.42	11.42	15.39	14.05	11.55	12.45
Class IV	Dol/cwt	10.81	10.00	13.20	12.88	10.65	11.00
All milk sold to plants	Dol/cwt	12.18	12.55	16.13	15.14	12.65	13.35

1/ Includes DEIP exports.

Chart 2. Consumption of Milk and Dairy Products

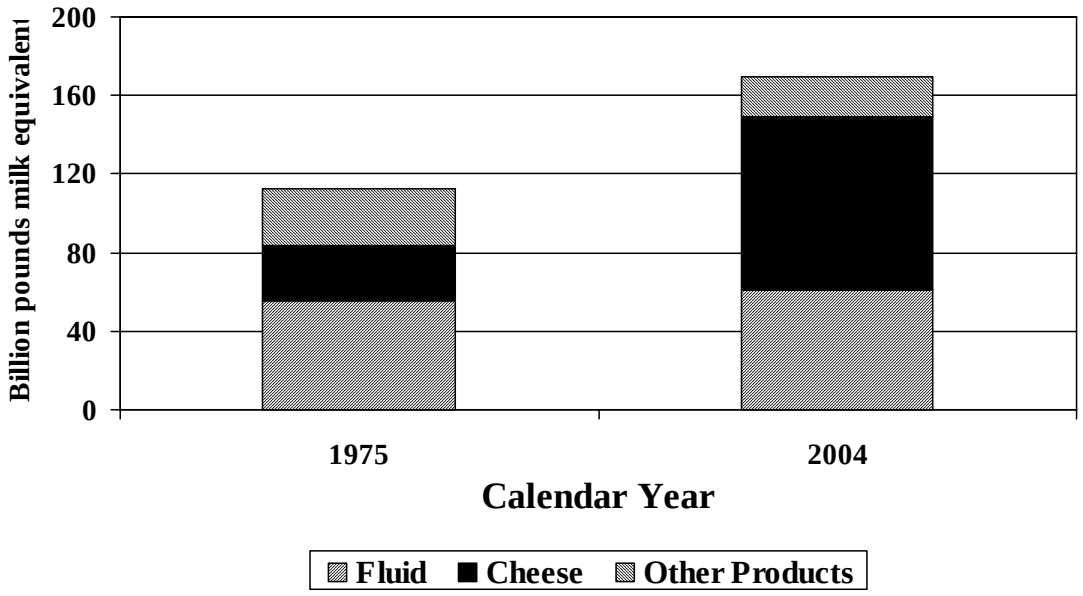

Chart 3. Number of Milk Cows and Milk Production Per Cow

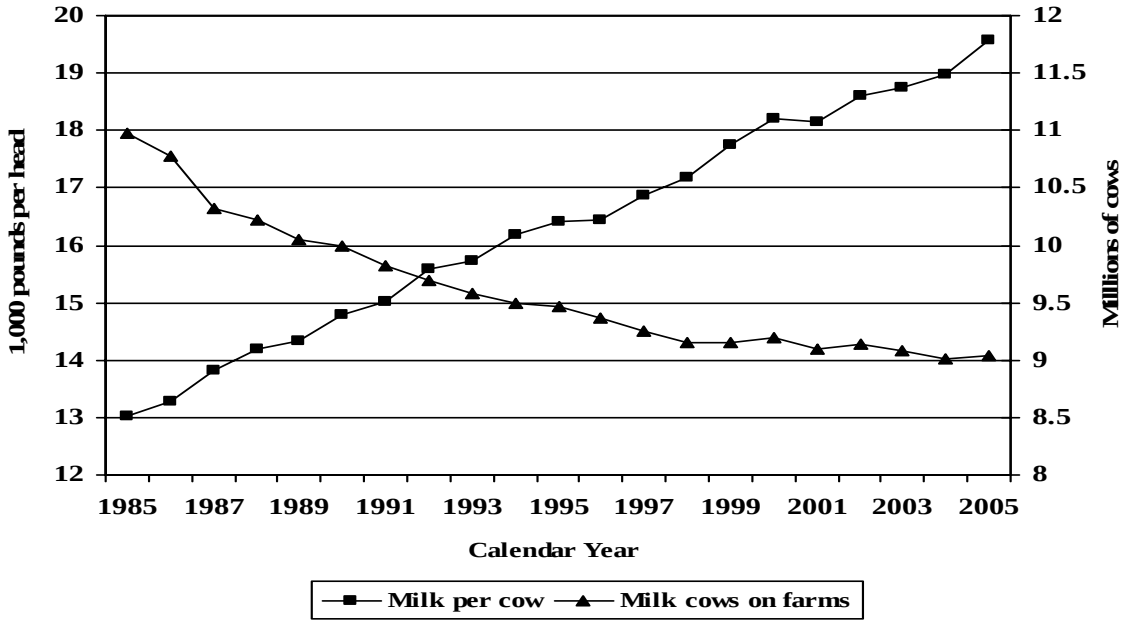

Chart 4. Milk Production: Changes in Regional Production Shares

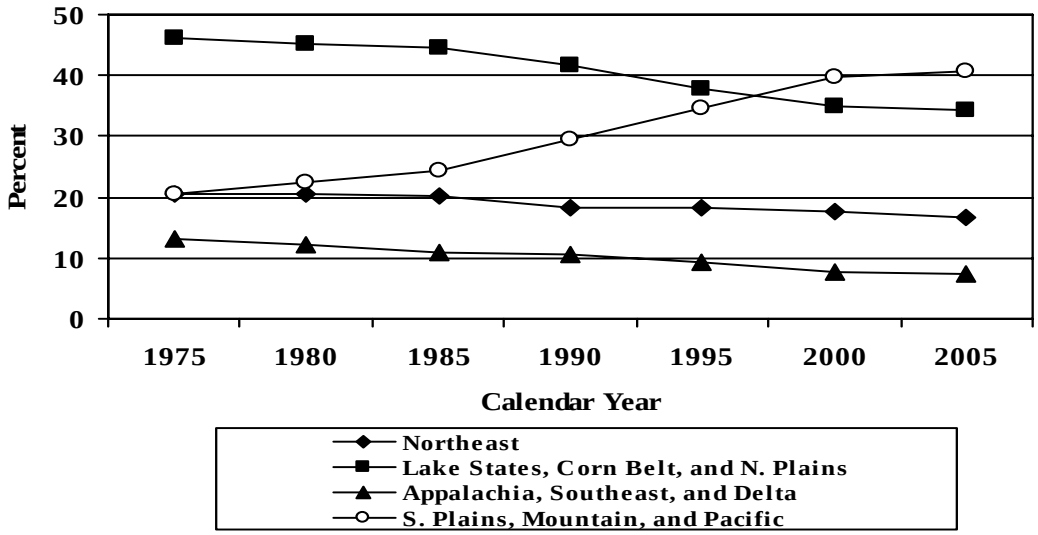

Chart 5. Number of Dairy Farms with less than 500 Cows and 500 or more Cows

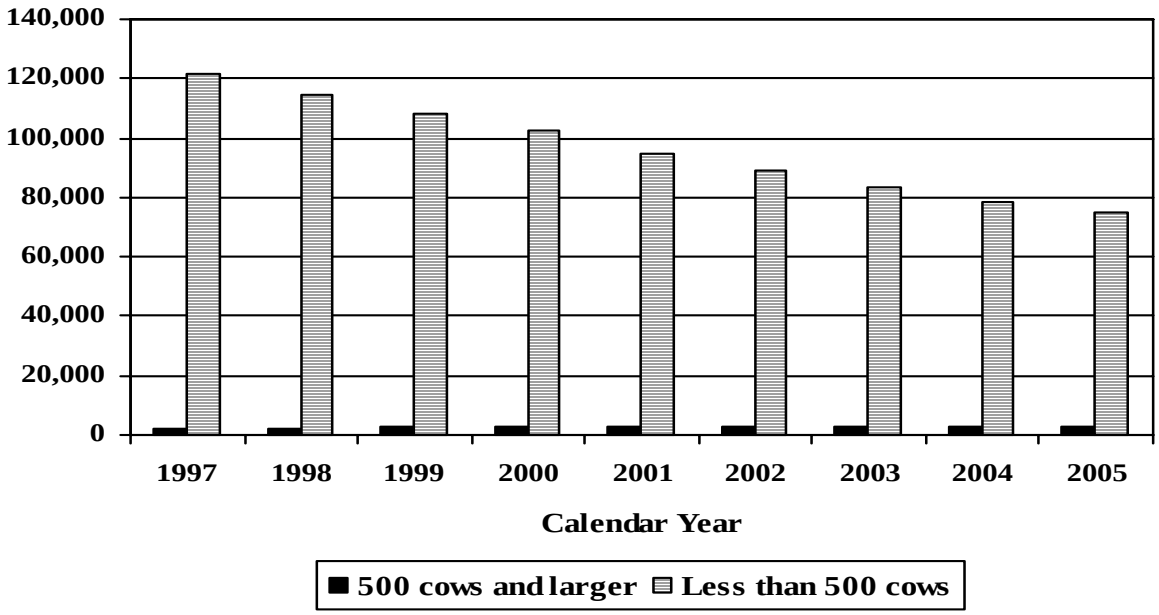

Chart 6. CCC Net Outlays for Dairy Programs

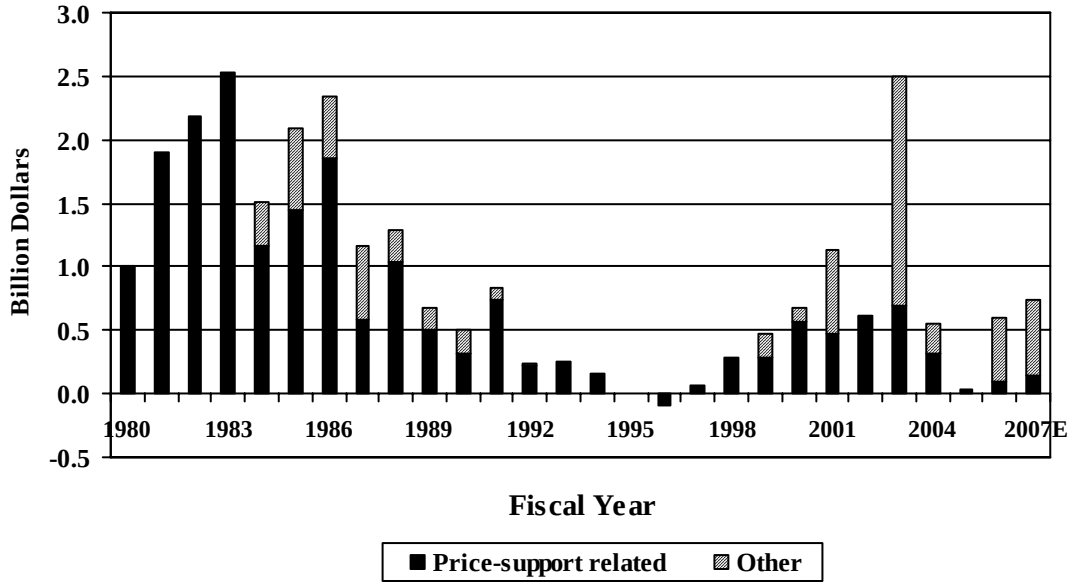

Chart 7. All-Milk Price and Support Price for Milk

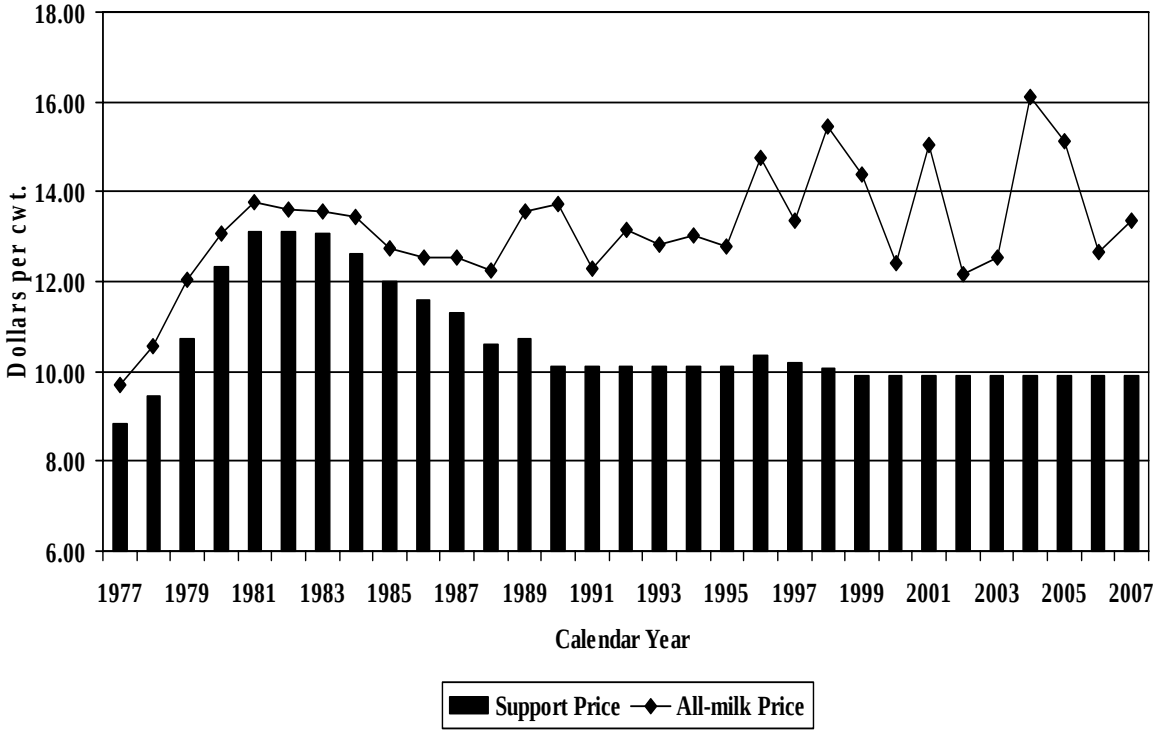

Chart 8. CCC Inventory, CCC Purchase Price and the Wholesale Price of Nonfat Dry Milk

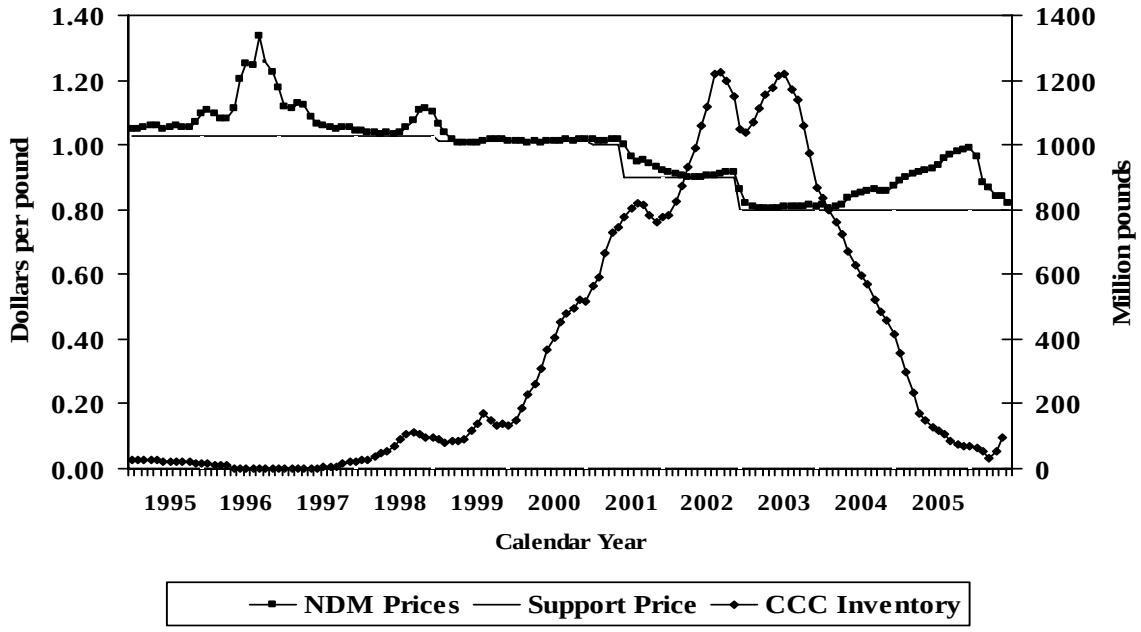

Chart 9. Nonfat Dry Milk Production, Purchases and Exports

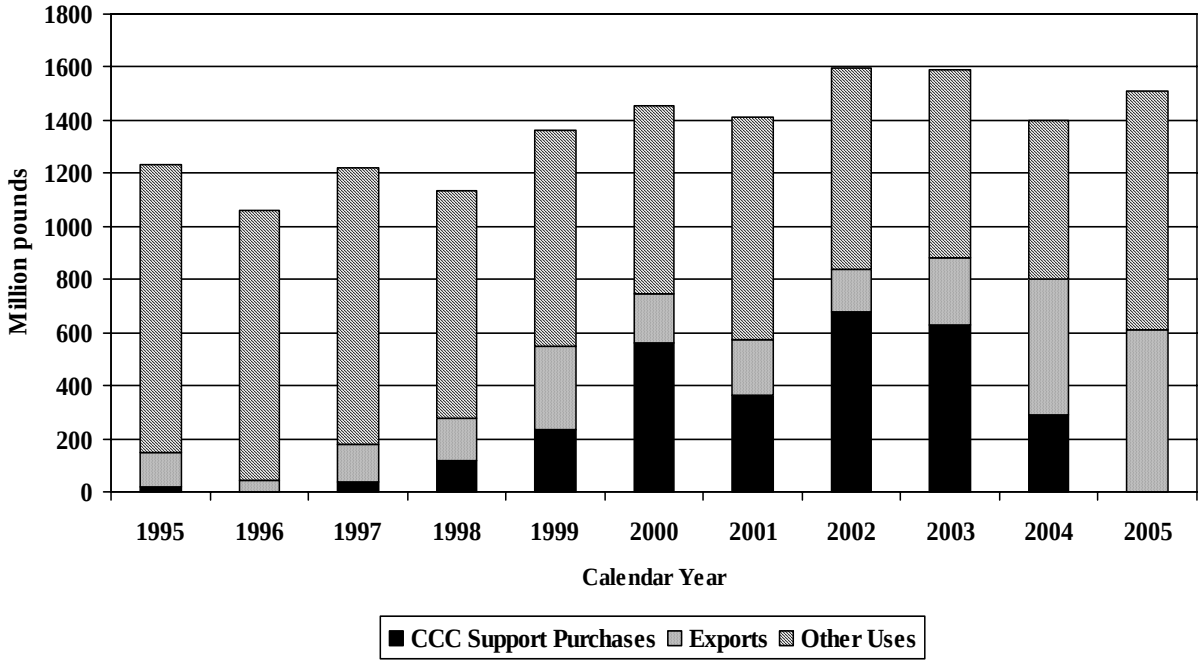

Chart 10. U.S. Imports of Selected Dairy Products (mil. pounds)

Calendar Year	Butter and Butter Equiv. of Butter Substitutes	American Cheese	Cheese Other Than American	Milk Protein Concentrate	Casein
2000	30.2	45.9	370.1	142.9	163.5
2001	82.3	68.6	368.1	78.1	135.8
2002	36.1	84.0	388.2	91.4	126.8
2003	33.2	68.0	408.6	106.4	153.1
2004	55.0	66.6	393.8	96.6	147.2
2005	42.9	40.2	392.4	121.3	153.9

Source: U.S. Census

Chart 11. U.S. Exports of Selected Dairy Products (mil. Pounds)

Calendar Year	Butter and Butter Equiv. of Butter Substitutes	Cheese	Skim Milk Powder [1]
2000	18.1	105.3	185.7
2001	8.4	115.4	211.8
2002	8.5	118.8	164.0
2003	25.5	114.9	249.9
2004	19.8	135.3	510.6
2005	18.9	126.8	610.8

Source: U.S. Census